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Transaction Update: Dwr Cymru (Financing) Ltd.

Primary Credit Analyst:
Tania Tsoneva, CFA, London (44) 20-7176-3489; tania.tsoneva@standardandpoors.com

Secondary Contact:
Roneil Thadani, London (44) 20-7176-3891; roneil_thadani@standardandpoors.com

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Ratings Detail

Table 1

Current Issue Rating*				
Class	**Current rating**	**Current balance (Mil. £)§**	**Interest (%)**	**Final maturity**
Class A1	A/Stable	350.0	6.015	2028
Class A4	A/Stable	373.7	RPI + 3.514	2030
Class A5	A/Stable	121.5	LPI + 3.512	2031
Class A6	A/Stable	124.2**	4.473	2057
Class B1	A/Stable	325.0	6.907	2021
Class B3	A/Stable	181.3	RPI + 4.377	2026
Class B4	A/Stable	107.2	LPI + 4.375	2027
Class B5	A/Stable	62.1	RPI + 1.375	2057
Class B6	A/Stable	293.3	RPI + 1.859	2048
Total	N/A	1,938	N/A	N/A

*On March 31, 2013. ¶Outstanding amounts include accretion. N/A--Not applicable. RPI--Retail prices index. **An index-linked swap has been used to change the original 4.473% coupon to 1.35%.

Table 2

Transaction Participants	
Borrowers	Dwr Cymru (Financing) Ltd.
Servicer	Dwr Cymru Cyfyngedig
Co-arrangers	RBS, HSBC
Borrower/issuer security trustee	Deutsche Trustee Co. Ltd.
Liquidity facility provider	RBS, HSBC, Lloyds TSB, National Australia Bank
Interest hedge provider	RBS, HSBC, Barclays, Lloyds TSB
Bank account provider	RBS
Principal paying agent	Deutsche Bank
Guarantor	MBIA U.K. Insurance Ltd.

Table 3

Supporting Ratings	
Institution/Role	**Ratings**
Barclays Bank PLC as swap counterparty	A/Stable/A-1
Lloyds TSB as swap counterparty and liquidity facility provider	A/Negative/A-1
HSBC Bank PLC as swap counterparty and liquidity facility provider	AA-/Negative/A-1+
National Australia Bank Ltd. as liquidity facility provider	AA-/ Stable/A-1+
The Royal Bank of Scotland PLC as swap counterparty and liquidity facility provider	A/Negative/A-1
MBIA U.K. Insurance Ltd as guarantor of class A debt	B/Stable/--

Table 4

Financial Highlights*	
Free cash flow (Mil. £)	(28)
EBITDA (Mil. £)	342
Regulated asset value (Mil. £)	4,344
Debt to regulated asset value (%)	63.6

*Year ended March 31, 2013

Table 5

Transaction Key Features	
Closing date	May 10, 2001
Collateral	Dwr Cymru (Financing) Ltd.'s debt is secured by first fixed and floating charges on assets to the extent permitted by the Water Industry Act 1991 and Welsh Water's Instrument of Appointment. Security includes Welsh Water's accounts receivable, contracts, bank accounts, and all assets except protected land. In addition, the other entities in the Glas Cymru structure--Glas Cymru, Dwr Cymru (Holdings) Ltd., and Glas Cymru (Securities)--guarantee Welsh Water's obligations.
Country of origination	U.K.
Financial covenants	Senior and Class C RAR: 95.0%
	Senior interest cover ratio: 1.6x
Trigger events	Senior interest cover ratio: 2.0x
	Senior post-maintenance interest cover ratio: 1.0x
	Senior and Class C RAR: 90%
Liquidity facility size (Mil. £)	135
Revolving credit facility (Mil. £)	140

RAR--Regulated asset ratio.

Rationale

The Dwr Cymru (Financing) Ltd. (Dwr Cymru) transaction is a corporate securitization that originally closed on May 10, 2001. The transaction is backed by the future cash flows generated by Dwr Cymru Cyfyngedig's (Welsh Water's) fully regulated and relatively low-risk water assets. Dwr Cymru is a special-purpose financing vehicle that onlent the proceeds of its issuance to Welsh Water, the regulated water and sewerage utility. Welsh Water supplies water and wastewater services to 1.3 million properties across most of Wales and some adjoining areas of England. It is owned by nonprofit Glas Cymru Cyfyngedig (Glas Cymru)

Standard & Poor's Ratings Services rates Dwr Cymru's long-term senior secured debt, the subordinated debt on its medium-term note program, the class A debt guaranteed by MBIA U.K. Insurance Ltd and outstanding class B debt. Under our criteria, ratings on monoline-insured debt issue reflect the higher of the rating and outlook on the monoline and Standard & Poor's underlying rating (SPUR). Therefore, the rating on the class A bonds guaranteed by MBIA U.K. Insurance Ltd. reflects the higher SPUR rating.

The ratings on the debt continue to reflect Welsh Water's underlying credit quality and our view of the various structural features designed to increase cash flow certainty for bondholders. The ratings are also underpinned by our assessment of Welsh Water's business risk profile as "excellent" and "aggressive" financial risk profile.

We consider Welsh Water's "excellent" business risk profile to be underpinned by the stability of the company's regulated monopoly water and wastewater business. In our view, Welsh Water benefits from the generally supportive and transparent regulatory framework for the water sector in England and Wales, and its position as a natural monopoly provider of water in its service area. At the same time, as with all water companies in England and Wales, we consider that Welsh Water is exposed to regulatory reset risk every five years. The price review consultations for the next regulatory period (beginning April 2015) are now under way and we are monitoring the impact of any developments closely.

In our opinion, Welsh Water's business risk profile is weaker than that of some of its peers; the regulator ranked it as having lower operational efficiency in the last price review. As a result, Welsh Water was set tougher efficiency targets for the current regulatory period (asset management period 5, or AMP5). So far, Welsh Water has demonstrated a good track record in meeting these targets and meeting the key performance indicators set by the regulator. Although we expect operating costs to be higher than previously expected going forward, we anticipate that Welsh Water will manage to stay within its regulatory allowances.

Welsh Water's "aggressive" financial risk profile is constrained by its weak cash flow metrics. Its adjusted funds from operations stood at 6.8% of debt for the year ending March 31, 2013 (2012: 5.4%). We consider that the relatively weak ratio reflects Welsh Water's high spending on infrastructure renewals expenditure and high indexation resulting from inflation linked debt, which we deduct from FFO. That said, the ratio has improved compared with last year due to the lower charge on index-linked debt.

That said, the company is owned by nonprofit Glas Cymru, which eliminates pressure to leverage the balance sheet through shareholder distributions. This, combined with the moderate capital investment program during AMP5, should result in average discretionary cash flows (DCF: after capital expenditure and dividends) that are at least neutral. As a result, Welsh Water's leverage is lower than its corporate securitization peers at 63.6% of regulatory capital value (RCV).

The ratings also reflect the structural enhancements of this corporate securitization, which include the liquidity mandated within Dwr Cymru's financial structure, a strong overall covenant package, and strict limitations on business activities. The senior debt is structurally protected because the junior debt is subordinated and cannot force a default of the senior debt. Further support is provided by Dwr Cymru's track record of continuously deleveraging. Its board is committed to maintaining the net debt to RCV ratio at or around 70%.

Outlook

The stable outlook reflects our view that, despite the tough efficiency targets, Welsh Water will keep within its cost allowances. It also reflects our opinion that Welsh Water will be able to maintain at least adequate operational performance and a good track record as an asset operator. We anticipate that the company will continue to reduce its leverage and will observe its internal policy of 70% net debt to RCV. We also anticipate that Welsh Water will generate at least neutral discretionary cash flows on average during AMP5.

We could lower the rating if we see weaker operational performance or deviation from cost allowances. Either could lead us to revise our assessment of the company's business risk profile to strong from excellent. The related adverse effect on operating margins could weaken cash flow coverage (in terms of DCF to debt). In addition, we could lower the rating if we see any change in the customer rebate policy, or evidence of pressure to increase balance sheet leverage.

At this stage, we consider that there is limited scope for higher debt ratings, as the financial covenants in the documentation for the medium-term note program allow Dwr Cymru to operate at high leverage.

Surveillance Analysis

Dwr Cymru has experienced positive or neutral free operating cash flows (after capital expenditures) and has not given customer rebates in the current regulatory period so far. In addition, inflation has consistently been high. As a result, Dwr Cymru's leverage has fallen to 63% net debt to RCV as of March 31, 2013 from 93% in 2001 (when the corporate securitization was implemented). The company has thus exceeded its target of reducing leverage to about 70%. Leverage is also considerably lower than Dwr Cymru's trigger and default covenants (90% and 95% net debt to RCV, respectively).

We anticipate that the company will continue to reduce its leverage, although we understand that it will reserve some headroom under the net debt to RCV covenant to account for potential differences in inflation indexes at the end of AMP5.

The premaintenance interest coverage ratio improved to 4.1x in the financial year ending March 31, 2013 from 3.0x in financial 2012, when the company had higher cash settlements on swaps linked to the retail prices index (RPI). We expect this ratio to remain robust at around 3.5x for the rest of the regulatory period.

In our view, the transaction's ability to meet debt service payments has slightly deteriorated since our last review. This is due to the following factors:

- Although we view the business risk profile as "excellent," we see it as weaker than some of Welsh Water's peers due to its below-average ranking on operating efficiency.
- We view the financial risk profile as "aggressive."
- We expect Welsh Water's operating expenditures to increase due to a combination of power costs, bad debts, and employee-related expenses. That said, we still expect Welsh Water to be able to meet what we view as tough cost allowances set by the regulator, the Office of Water Services (Ofwat) for AMP5.
- Cash flow coverage of debt remains relatively weak for our assessment of Dwr Cymru's underlying credit quality, partly due to consistently high inflation.
- Dwr Cymru continues to perform and to maintain good headroom to its trigger and default covenants under various stress scenarios.

Strengths, Concerns, And Mitigating Factors

Strengths

- The generally supportive and transparent regulatory framework in the U.K. water sector, which ensures a high degree of stability and predictability of earnings and cash flows. The regulatory structure is designed to provide companies with high-quality cash flows that are sufficient to finance their operations, provided they meet specified, preagreed operational and financial targets.
- Lack of competitive threat and high barriers to entry in the company's appointed area. In the absence of genuine competition, Ofwat has established surrogate competition through regulatory comparison. Steady progress in meeting Ofwat's targets for operational performance over the current AMP5 regulatory period. In 2012/2013, Welsh Water met all its operating targets set by Ofwat. In particular, it improved the serviceability of its sewerage assets, which were inadequate last year. The company also improved its customer service measures, which are measured, in part, using the service incentive mechanism score.
- Declining leverage ever since May 2001, when the corporate securitization was implemented. For the year ending March 31, 2013, Welsh Water's leverage was 63.6%, measured as net debt to RCV (2012: 65.1%), which is much lower than its corporate securitization peers and lower than the board-set internal target of about 70%. We expect leverage ratios to remain around 60% for the rest of AMP5.

Concerns

- Welsh Water's lower ranking on operational efficiency than its peers in the last price review has resulted in tougher efficiency targets in AMP5. The company was classified in the lowest band for relative operating efficiency. This band determined the catch-up factors that will help Welsh Water close the gap between it and the most efficient companies.
- The company's price decrease was the largest of all the water and sewerage companies regulated by Ofwat and yet it implemented a capex program similar in size to that of the previous regulatory period. It also had to meet challenging cost efficiency targets. The risks associated with the regulatory reset reviews undertaken by Ofwat every five years. The company is currently in the fourth year of a five-year regulatory period effective from April 1, 2010, until March 31, 2015.
- Weak cash flow coverage ratios. For the year ended March 31, 2013, Dwr Cymru's Standard & Poor's-adjusted funds from operations (FFO) interest coverage of total debt and adjusted FFO to debt stand at about 2.1x (financial year 2012: 1.8x) and 6.8% (2012: 5.4%), respectively. The ratios improved compared with last year, in line with our expectations due to the lower impact of indexation from inflation-linked debt. That said, cash flow credit metrics remain weak compared with peers due to the company's relatively low operating efficiency, high spending on infrastructure renewals, and indexation charges. We anticipate that cash flow ratios will remain around current levels for the remainder of AMP5. That said, we forecast discretionary cash flows that are at least neutral, on average. We view this as a credit support in a capital-intensive sector such as U.K. water utilities.

Mitigating factors

- Protective structural features. These include considerable cash reserves and liquidity facilities, which allow for continued debt servicing under stress; a comprehensive security package (limited by the standard restrictions that apply to the sector); an intercreditor agreement minimizing the rights of junior lenders; and a tight covenant package, which provides the senior bondholders with significant powers to influence the company in times of stress.
- Substantial financial flexibility, which stems from Glas Cymru's nonprofit structure and unused borrowing capacity. Instead of a dividend, the company can choose whether to rebate the cash generated in excess of targeted financial reserves to customers.
- Neutral free operating cash flows, despite substantial capex commitments over the medium-to-long term. Over 2010–2015, we think that Glas Cymru is likely to generate at least neutral-to-positive free operating cash flows for the first time, thereby lessening the need for ongoing borrowing. We base our forecast for this five-year period on a

capex program of about £1.1 billion at 2007-2008 prices, and the assumption that capex is heavily maintenance-focused.
- Insulation from volatile credit market conditions through a prudent treasury policy embedded in the common terms agreement for managing interest-rate, counterparty, and liquidity risks. Currently, almost all borrowings are at fixed or index-linked interest rates, partly through the use of interest rate and RPI swaps. Refinancing risk is mitigated through long-dated borrowings and a restriction of no more than 20% of maturing debt in any two-year period.
- Some flexibility in the revenue-setting regime, provided by Ofwat's "Interim Determination of K" (IDoK) mechanism. The mechanism allows a company to reapply for a revenue increase in the middle of a five-year period if its performance is affected by unexpected changes (under specified circumstances). We regard this adjustment to price limits as providing some protection against cash flow-erosion risk during each five-year regulatory period, although it does not cover all costs, nor does it cover erosion in the RCV due to deflation. For example, the recent significant increase in energy costs was not covered by the IDoK mechanism.

Performance Of The Dwr Cymru (Financing) Transaction

Amortization schedule

Dwr Cymru continues to comply with the debt maturity limitations as mandated under the corporate securitization documentation. The next significant maturity is £325 million of class B notes in 2021. There are no mandatory break clauses in the index-linked swaps. Dwr Cymru does not have any class C bonds on issue.

Key covenants performance

Table 6 shows financial covenants, Standard & Poor's base-case forecast for 2012, and Dwr Cymru's actual performance in the year to March 31, 2013.

Table 6

Key Covenants*

Financial covenant	Restricted payment condition*	Standard & Poor's base-case forecast 2013	Actual performance March 31, 2013	Company forecast performance March 31, 2012	Covenant status
Senior and Class C RAR	90%	65%	63%	64%	Met
Senior ICR	2.0x	3.5x	4.1x	3.8x	Met
Senior PMICR	1.0x	1.7	2.0x	1.9x	Met

*For ICR ratios, trigger event covenant is displayed. ICR--Interest cover ratio. PMICR--Post-maintenance interest cover ratio.

Dwr Cymru has outperformed our base-case forecasts for net debt to RCV because of consistently high inflation in the U.K. The same factor, however, makes meeting interest cover ratio covenants more difficult as pay-as-you-go swaps are settled in cash each year. We have rerun various sensitivities as part of our review of Dwr Cymru. The outcomes do not contradict our rating assessment, in our opinion, as the stresses that we applied are appropriate for the current rating level. Dwr Cymru performs adequately under our sensitivities. Given the considerable headroom under its covenants at present, we do not expect Dwr Cymru to reach trigger levels, and consider it even less likely to reach default levels under any of the sensitivity scenarios.

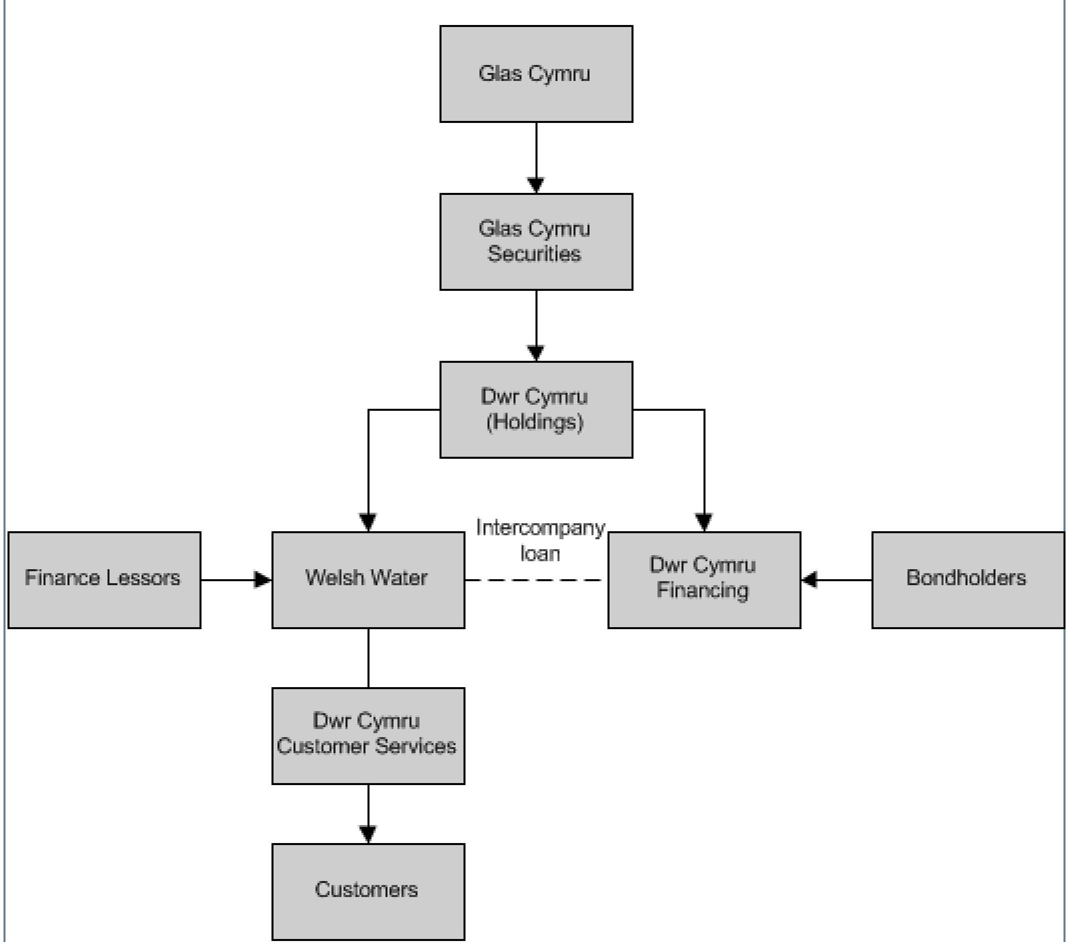
In addition to our base-case scenario, we have applied the following sensitivities:

- Standard & Poor's base case plus deflation of 2% in 2013, 1% in 2014, and 2% thereafter. We assume the rate of deflation is less for operating costs than for revenues, because the former can be relatively inflexible and not immediately passed through to customers.
- Standard & Poor's base case plus 1% inflation for the duration of the transaction.
- Standard & Poor's base case with the weighted average cost of capital (WACC) cut by 50 basis points from the next regulatory period.
- Standard & Poor's base case, assuming a 5% increase of operating costs above the regulatory allowance in each year.
- Standard & Poor's base case, assuming 10% higher capex (not included in RCV) in each year.
- Standard & Poor's base case with stressed funding costs, i.e., 200 basis points higher than Dwr Cymru's assumptions, applied to all financing and refinancing costs.
- Combination of lower weighted-average cost of capital, 10% capex overspending, and high funding costs.
- Combination of operating expenditures (opex) and capex overspending.
- Combination of low inflation, lower weighted-average cost of capital, and 5% opex overspending.

Transaction Structure

The structure of the transaction is shown in the following chart.

Glas Cymru Financing Structure



Business Description

Dwr Cymru is an SPV that is owned by Glas Cymru, a Welsh nonprofit company. Dwr Cymru is controlled by members with no financial interest in the company. The financial beneficiaries of outperformance are primarily the customers, and, to a lesser extent, investors, although the latter also bear some underperformance risk. This unique ownership structure distinguishes Glas Cymru from other U.K. water utilities because it eliminates any pressure for dividends and other shareholder returns.

The operating company, Welsh Water, is the sixth largest of the 10 regulated water and sewerage companies in England and Wales according to RCV, which for Welsh Water was £4.3 billion on March 31, 2013. It supplies water and wastewater services to 1.3 million properties across most of Wales and some adjoining areas of England.

Business Risk Profile

Overall, we continue to assess Welsh Water's business risk profile as excellent, reflecting the stable and predictable revenue and cash flow streams from the low-risk regulated water and waste water businesses; its natural monopoly position in its service area; and a generally supportive and transparent regulatory framework. The group is exposed to risks arising from the regulatory reset every five years, with the next regulatory price control period starting in April 2015. We expected the final determinations for the next regulatory period to be published in 2014, and we will monitor related developments closely.

Welsh Water's lower ranking on operational efficiency than its peers has resulted in tougher efficiency targets. We consider that Ofwat's latest determination set Welsh Water a relatively tough set of allowances, requiring a 4% drop in cumulative revenues and operating efficiency cuts of about 20% in real terms. Although we view Welsh Water's cost allowances as challenging, we anticipate that the company will manage to meet them. Our opinion is supported by Welsh Water's adequate performance compared with its business plans in the first three years of AMP5, and the substantial portion of contracted costs for this regulatory period.

Financial Risk Profile

Welsh Water's financial risk profile is "aggressive," in our view. It is constrained by its relatively weak cash flow metrics--adjusted funds from operations stood at 6.8% for the year ending March 31 2013 (2012: 5.4%). The ratio is constrained by relatively low profitability, high infrastructure renewals expenditure and the negative impact of indexation. That said Welsh Water has relatively lower leverage, with S&P adjusted debt at 63.6% of RCV. This is the result of the nonprofit ownership structure by Glas Cymru, which eliminates pressure to leverage the balance sheet through shareholder distributions. This, combined with the moderate capital investment program during AMP5 should result in DCF after capital expenditure and dividends that are at least neutral, on average.

Related Criteria And Research

- Counterparty Risk Framework Methodology And Assumptions, June 25,2013
- Methodology For Considering Pre-Insolvency Structural Protections In Europe, Dec. 13, 2012
- Methodology And Assumptions: Recognizing The Sustainable Cash Cost Of Inflation-Linked Debt For Corporates, Feb. 10, 2009
- Enhanced Competition Could Alter Standard & Poor's Assessment Of The U.K. Water Sector, Dec. 12, 2008
- Methodology For Rating And Surveilling European Corporate Securitizations, Jan. 23, 2008
- Exploring The Keys To Success For U.K. Water Corporate Securitizations, Dec. 14, 2006

Additional Contact:
Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com